ofgem E-Serve

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Promoting choice and value for all gas and electricity customers

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Dear Fiona,

NIRHI – Operational funding for 2013/14 and outyears

Further to our recent correspondence, I am writing to provide you with some further analysis of NIRHI scheme costs to date and to propose an adjustment to the way we calculate funding for 2013/14 and beyond. This proposal is a simple modification to the existing agreed formula which will enable Ofgem to better achieve cost recovery in the event that volumes are low, while also not increasing costs for DETI should volumes be as expected or higher.

Previous agreed funding formula and funding estimate
As you are aware, the Baseline scope provided in 2012 set out estimated costs for the operational aspects of NIRHI at the following amounts:

2013/14	2014/15	2015/16
£164,636	**£223,809**	**£341,629**

It also provided the following formula for determining what Ofgem would charge DETI for the administration of the NI RHI:

"We anticipate costs for NIRHI will be around 3% of total scheme operating costs. As a result, we propose to charge on the following basis that DETI costs = Total RHI operating cost Value of NI tariff payments / Value of Total (NI+GB) tariff payments."*

At the time it was envisaged that this formula would give a reasonable approximation of Ofgem's administration costs, thus allowing Ofgem to recover costs. However, now that we have been operating the NIRHI for six months we have data which indicates that the agreed formula may not in fact be appropriate in 2013/14 as it could result in Ofgem receiving insufficient funds to administer the NIRHI in the event that the low scheme volumes experienced so far were to continue. We do not think we have the vires to cross subsidise NI related costs with GB licence fee funds, nor do we think it would be appropriate to do so. Therefore we need to renegotiate the funding level to ensure the full scheme costs are recovered in the event of low volumes.

Why the formula may not cover Ofgem's costs in 2013/14
Some resource requirements associated with running a scheme are not proportionate to the number of applications or the value of payments (see Annex 1) as, for example, there are significant fixed costs including baseload tasks and management time liaising with DETI etc. If application numbers and payment values were to come forward as expected, then the amount charged may be sufficient to cover those non-proportionate costs. However, actual numbers of applications to date have been very low, providing no scope going forward to absorb additional non-proportionate costs should these volumes continue. Fuller details of the proportionality issue are provided in Annex 1.

In addition to the proportionality issue, the timing of tariff payments lag significantly behind much of the work carried out by the operational team. Payments are not usually made for several months after the enquiry and application handling stage. This depresses charges in any year in which the number of applications is growing. The projections are that GBRHI application numbers and NIRHI application numbers will both grow throughout the lifetime of the scheme, but because NIRHI started considerably later than GBRHI it is considerably behind GBRHI on the growth curve. Therefore there is the possibility that basing charges on this lagging indicator will mean that DETI would be charged only for a small percentage of the work done on NIRHI in any year, and this proportion would be disproportionately smaller than the GB scheme for which more payments are coming through. However, the proposal that we are making below on recovering fixed costs at low volumes should take care of this issue at low volumes. Because of this, and given that we need to obtain more operational evidence before we can determine the impact that this lag may have, we do not currently propose to make any changes to the charging formula to address this (over and above the "fixed cost" change being introduced for low volumes). Instead we propose that this be revisited in April 2014.

Alternative funding calculation options
For the reasons set out above and in Annex 1, it is not certain that the agreed formula will provide adequate funding for NIRHI in 2013/14 and beyond. The following alternatives to the agreed formula have been considered:

1) **Full costing**
The finance team at Ofgem could provide a full actual costing for NIRHI. However, there would be costs associated with this option. Either it would it be necessary to have separate NIRHI or a strict allocation of a proportion of their time to NIRHI staff (resulting in inefficiencies), or we would need to introduce detailed timesheeting not just for all RHI staff, but all IT staff, all finance staff, all HR staff, all senior management and other staff. In addition all associated costs would have to be passed on to DETI including a charge for the work done by the finance and management teams to provide the necessary level of detail on a regular monthly basis, and a charge for the cost of operating timesheeting. As this is likely to be the more expensive option, and it requires a significant change to Ofgem's practices which would be difficult to justify on the basis of such a small fraction of the total Ofgem budget it has not been investigated in detail.

2) **A charge based on a fixed and variable portion**
A two-tier charge with a set fixed charge and a variable amount based on proportion of payments would enable us to cover baseload costs even at low volumes.

Option 2 is our preferred approach and the rationale for it is provided below.

The "fixed" charge (i.e. recovering for costs incurred where tariff payments are below 3%)

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In the event that tariff payments to NIRHI participants is less than or equal to 3% of total scheme payments in any one financial year, it is proposed that a fixed proportion of 3 per cent of the RHI operational budget be paid to Ofgem to cover the administration of the NIRHI. We have considered all the major cost categories and given the rationale for this "fixed" percentage for each below:

1) **Staffing costs**
In the first months of operation, 3.75 per cent of total operational staff time was spent on NIRHI. It is assumed that this is greater than would be needed once we reach steady state. By removing hours spent on actual processing of applications, which will vary with the number of applications received, this figure can be reduced by around 10 per cent. A further reduction has then been applied to allow for steady state efficiencies to provide a simple calculation that a fixed 3% of operational costs should be attributed to NIRHI. It is proposed that this be provided as a fixed amount to allow for appropriate planning and budgeting. Provision at this level will also allow for sufficient audit procedures to be put in place.

   Separate to this 3% staff level, we have also found that senior management time spent on the NIRHI has at times been much greater than 3%, as the administration arrangements and other stakeholder management requirements have taken up a disproportionate amount of time. We consider this to be closer to 5-10% to date. We anticipate that this will reduce over time to a level around 5%.

2) **Audit**
The agreed funding mechanism would have allowed for perhaps one audit in 2013/14 if tariff payments remained in the ratio experienced to date. Audits can be considered a variable cost, i.e. the number of audits undertaken should increase with accreditations, or can be decided in some other way. We have considered an appropriate level of auditing (for instances where payment volumes are below 3%) to be the around midpoint of 0-3%. Allowing for 1.7% of expected total audits will provide sufficient funding for 5 audits. We are proposing this approach rather than introducing a volume related variable charge (on top of the proposed fixed charge) for volumes below 3% in order to keep the funding approach as simple and predictable as possible. However, you may wish to provide additional funding if you would prefer a larger sample.

3) **Recruitment**
A 3 per cent charge would allow us to recruit one member of staff for NIRHI, and current experience on the scheme indicates that this will be needed in 2013/14. Five people have been trained to work on NIRHI and we would expect at least two of them to be replaced during the coming year. The 3 per cent charge would meet part of the cost of recruiting one new member of staff.

4) **IT**
For these areas we have also assumed costs to be 1.5% for any activity below 3%. Again, we have taken the same logic approach as for audit costs, being that the proportion of IT spend varies according to volume, but we have taken the midpoint of 0-3% as being an appropriate level to charge at for low volumes, in order to keep the funding calculation simple. Note that costs of any improvements to the reporting part of the IT system will likely be out of proportion to the 3% level (as explained in Appendix 1) though we will discuss these separately with DETI in advance should we seek to make these improvements in future.

Although some costs have been taken to be below 3% on average (e.g. IT and audits), other costs are considered to be higher (mainly management time). On assessing these we have found that they are likely to balance out at 3% on average and would therefore propose that we charge a flat 3% level in order to keep the funding approach simple.

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In addition to the above costs, there are several other items where costs may not be in proportion to the percentage of payments or accreditations. Depending on whether these things eventuate, costs for them may be above or below 3%. However, taking them collectively, it is likely that total costs for these will more closely approximate 3% of total scheme costs for these categories, and therefore we would propose including them in the 3% charge. We have considered charging for these costs in another way, for example by amending the charging formula to recover actual costs for these items, but we would propose not to do this on the basis that it will complicate the funding calculations, as well as introduce significant extra costs and inefficiencies (e.g. with timesheeting) for potentially no benefit.

These other items include:

5) **Complaints and disputes**
Currently running at a low level, these may be sporadic or triggered by particular issues such as technologies or application type, and some of these issues may disproportionately affect NI based on the demographics of the region. A considerable proportion of complaints to date have arisen because of concerns that a particular technology is being unfairly treated. For example, ground source heat pumps were, at one stage, mired in technical and legal issues. Areas with more 'new build', or areas with more land available for ground or water source loops would be more likely to generate complaints of this nature. It seems theoretically possible that such issues might disproportionately affect Northern Ireland. Other complaints triggers have been grant funding issues. At present of the six accreditations for Northern Ireland, three have been car mechanical and other similar small workshops, but numbers are so low it is difficult to draw valid conclusions.

6) **Fraud and compliance**
Fraudulent activities are rare at present so even one case affecting NI would be a significant proportion of all the cases under consideration, potentially far outweighing the proportion of payments for the region. Experience so far is that a case arises for around every 350 applications. We are currently working on an assumption of NIRHI having 123 applications in 2013/14 so it should be likely that no cases will arise. However, should one do so it would be out of proportion to the GB scheme.

7) **Legal issues**
Issues specifically in relation to NI have already arisen such as the privacy policy. In the GB scheme there was a considerable bedding in period in which legal issues emerged. It is expected that the same will apply to NI. Should any further NI specific issues arise, then this could be out of proportion to the GB scheme. This is on top of resolving issues which are common to both schemes (e.g. under what circumstances care homes can be considered non-domestic), in which the costs can be considered proportionate. (See also the assumptions section below for more detail on legal costs).

The variable charge (costs incurred where tariff payments exceed 3%)
If NI tariff payments rise above 3 per cent of the scheme total, we propose to revert to the existing variable charge of a percentage of total operating costs. The amount would be calculated by assessing the proportion of payments which are NIRHI and charging the corresponding proportion of the scheme costs. The rationale for this is unchanged from the original rationale - with increasing volumes of accreditations, periodic data and payments also comes increasing volumes of enquiries, audits, non-compliance etc, and hence increasing workload requirements, an increased use of the IT system, increased audit volumes and a corresponding increased need to seek consulting advice.

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Proposed new funding formula for operating costs
The new funding formula that we would like to propose is therefore as follows:

We propose to charge on the following basis that DETI operating costs shall be the greater of:
- *(a) 3% of the total RHI operating cost, or*
- *(b) Total RHI operating cost * (Value of NI tariff payments / Value of Total (NI+GB) tariff payments).*

Expected cost breakdown
If we assume the proportion of tariff payments will be 3% or below, and if the above assumptions on costs incurred hold true, then this leads to the following costs being incurred:

Forecast RHI Operational Expenditure 2013/14	
Staff costs (operations and legal, recruitment and training)	£103,489
Consultancy (audits, technical and legal advice)	£13,109
IT operations (support, licences, hardware)	£13,470
Other (e.g. travel, stationery, events)	£2,703
Total excluding overheads	£134,398
Overheads (at 24%)	£31,865
Total including overheads	**£164,636**

Note that this amount is equivalent to the level of expenditure predicted for the scheme in 2013/14 as set out in the baseline scope as agreed in December 2012.

Assumptions made to underpin these costs
There are a number of assumptions which underpin the cost forecast for the scheme as a whole, and hence for the NI share of the scheme costs. These can be provided on request. However, I would like to bring two significant assumptions to your attention:

Firstly, this proposal has only taken account of operating costs incurred in running the NIRHI. As with the Baseline Scope agreement, no allowance has been made for any possible development expenditure in 2013/14 or beyond. Should any development be requested by DETI or Ofgem, then scope, timing and funding for it will be discussed and agreed between the parties before work commences.

Legal staff/consulting expenditure only covers the NI proportion of common legal costs incurred (i.e. to resolve legal issues likely to be common to both schemes, or to resolve issues which are likely to arise in the 3%/97% NI/GB ratio), as well as the base legal costs related to maintaining the administration arrangements and resolving the current issue of legal interpretation. Should significant further expenditure be needed on unforeseen legal costs or on the administration arrangements or current issue, then we will need to negotiate further funding. In addition, legal costs do not include any provision for Judicial Review costs. Should a Judicial Review arise in Northern Ireland, then we will also need additional funding to cover related costs.

For further consideration - FOI requests
FOI requests are growing in number and it is not clear to Ofgem that DETI expects us to be responsible for managing them. Again, the numbers to date are not large (although in one recent week 6 FOIs were received for GBRHI each taking up to six days, so the resourcing implications can be significant). DETI may wish to take on this aspect themselves, or alternatively to fund Ofgem to deal with FOIs. We would be grateful for clarification on this point.

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Finally, I would like to take the opportunity to let you know that we have a new Senior Manager, Teri Clifton, who is based in Glasgow and will be responsible for overseeing the NIRHI operations (under Jacqueline Balian's leadership). Teri will be looking after this funding issue through to its conclusion, and will also be managing the staff member responsible for day to day interactions with DETI on the scheme.

Teri and I will shortly be visiting so that we can discuss this proposal in more detail, in the meantime if you have any queries do please give Teri a call and she will look into it.

Yours sincerely,

Matthew Harnack

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Annex 1 - Proportionality

Although some resource requirements associated with running a scheme are proportionate to the number of applications, some are not.

Operational costs which *are* likely to be proportionate

These will include aspects such as:

- Most IT costs (including support, hardware and software, licences etc)
- Recruitment (varying in line with staff costs)
- Technical consultancy
- Travel (depending on how many trips to Belfast are required)
- Enquiries
- Overheads
- Legal expenditure on legal issues common to both GB and NI RHI schemes

Operational costs which are highly likely to be out of proportion

1) Divergence of schemes

As well as impacting on development and IT costs, divergence of the GB and NI schemes will impact on operational costs. Scheme divergence is highly likely, for example, it is not expected that the NIRHI scheme will be revised on the same timescales as the GB scheme. Under the GB scheme there will be changes in 2013/14 to the definition of complex systems. These changes will not be introduced for NI until considerably later. Staff will have to be trained to operate two different systems and monitoring will have to be put in place to ensure this is appropriately handled. While some of the changes to the GB scheme may increase scheme requirements, others, such as the metering changes, are expected to considerably reduce the amount of work needed to accredit an installation. Where these are delayed for NI, as well as the costs of divergence, there will be a resource cost for maintaining the more time consuming procedures for NI, which will make the costs of running that scheme disproportionately greater for NIRHI. A number of regulatory fixes which will simplify the accreditation process are also currently being considered by DECC.

2) Differences in application type

Although in theory the larger and more complex an application is, the more time it takes, in practice, particular characteristics can increase the time taken to process an application. For example, farmhouses are not usually business rated so establishing their eligibility for the non-domestic scheme can be very time-consuming. Such premises may be a disproportionate amount of NI work depending on the demographics of the area. Although as previously noted no farms in NI have applied for the scheme, and therefore we do not believe this is currently a factor, it may become a factor in the future.

3) Reporting and communication

All reports produced for GBRHI have to be replicated for NIRHI. This is not an additional 3% workload for these tasks, it is estimated to be closer to an additional 25% of staff time, taking into account that some of the issues will have been resolved in developing the GB report. Reporting currently utilises 4.8 FTEs per annum. We are working on making our reporting more efficient by developing our IT systems and have assumed these efficiencies in our projections of staff requirements this financial year.

IT development expenditure on reporting functionality is also not proportional at 3% of total expenditure. This is because a whole separate series of reports needs to be created for NI. While much of the up-front design or re-design work could be attributed to GB, the actual work on building the new reports or making the changes to the reports needs to be replicated for both GB and NI, meaning that costs of making the changes to the NI reporting functionality could be closer to 25% of total costs incurred on changing reporting.

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Should we need to make any further changes to reporting (such as in Phase 2 of scheme development) we will discuss and agree the costs with DETI in advance.

4) Timesheet reporting

Because it was recognised that not all tasks are proportionate to NIRHI payment levels, it has been necessary to ask all direct operational staff working on NIRHI to keep some form of timesheets of the work they do specifically on NIRHI. It is this timesheet reporting which has allowed us to have data upon which to base this analysis of the proportion of time being taken on NIRHI. It will also provide security, going forward, that we have accurately portrayed the cost of running the NI scheme to DETI. This is an administrative burden on those staff who have to complete timesheets, on their managers and on those reporting on their activity. Again, these activities are not necessary in relation to the GB scheme. Note however that as mentioned earlier, we have not currently introduced more widespread timesheeting (e.g. of HR staff, finance staff, or senior management staff) which would be required to move to an actual charges basis.

5) Staff training

In order to manage the RHI scheme we have to have different staff able to carry out the following tasks:

- Operational management
- Application processing (+leave cover)
- Enquiry handling (+leave cover)
- Level three reviews (+leave cover)

Although these individuals will not need to spend 100% of their time on NIRHI, they will all have to be trained so the training overhead is higher for NIRHI. Because the absolute numbers of staff employed on these tasks is so low, a full extra person has to be trained in each area to provide cover. In the GB scheme, training one extra member of staff will provide cover for many postholders. Therefore the training burden will not be proportionate to that of the GB scheme.

6) Updating guidance material

As the NI scheme is based on a different set of legislation to the GB scheme we have also had to publish a separate guidance document and guidance material. Any updates to the guidance material, due for example to a streamlining of processes or due to feedback which prompts us to clarify a statement, will need to be carried out for both the GB material and the NI material. This will therefore be out of proportion to the 3%. As with reporting we anticipate this to be closer to 25%.

7) Management of the scheme

Managing the relationship with DETI may not take the same amount of effort as managing the relationship with DECC, since, for example, we do not have to attend monthly meetings with DETI. Nonetheless it is considerably more than 3% of the work associated with managing the relationship with DECC especially given travel times to DETI etc.

It is these tasks which, along with scheme management and reporting, form the baseload of tasks for RHI which may not be proportional to the same tasks for the GB RHI scheme.

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